

the second step outlined below. The auditing firm voluntarily would trigger the operation of this mechanism upon the occurrence of potentially catastrophic events specified in the partnership agreement, such as civil litigation or actual or significantly threatened government or regulatory action. If necessary, the SEC and the PCAOB could encourage the firm to trigger the mechanism through private communications, public statements, or other means. Regulators could also assist in maintaining the firm's organization intact by, for example, increasing the time period for registrants that are audit clients to have audits or reviews completed and providing accelerated consultative guidance to registrants that are audit clients.¹⁵⁴ The Committee recognizes the precise details of such a mechanism would vary from auditing firm to auditing firm, depending on firm structures, history, and culture.

Second Step—External Preservation Mechanism

The Committee also recommends that the larger auditing firms establish in their partnership agreements a rehabilitation mechanism under SEC oversight. The failure of the internal governance mechanism to preserve the auditing firm outlined in the first step above would trigger this second step, which would require legislation. Upon triggering of the second step, either voluntarily by the firm or by the SEC, the SEC would appoint a trustee, subject to court approval, whose mandate would be to seek to address the circumstances that threaten survival, and failing that, to pursue a reorganization that preserves and rehabilitates the firm to the extent practicable, and finally, if reorganization fails, to pursue an orderly transition. If this second mechanism is to include an element that addresses claims of creditors (which could include investors with claims, audit and other clients, partners, other employees, and others), legislation to integrate this mechanism with the judicial bankruptcy process may be necessary.

It is important that this mechanism not be used as insurance for partner capital; that is, this mechanism should not be developed to "bail out" a larger auditing firm, but rather to preserve and rehabilitate the firm in order to ensure the stable functioning of the capital markets and the timely delivery of audited financial statements to investors and other financial statement users. Accordingly, there must be powers that can be exercised in furtherance of the objective of holding the firm together.¹⁵⁵

The Committee also notes that the larger auditing firms are members or affiliates of global networks of firms and rely on these networks to serve their global clients. Since the networks are maintained through voluntary contractual agreements, the fact that a U.S.-based firm may be facing threatening circumstances could lead to the disintegration of the network. In this regard, in developing this mechanism, auditing firms, regulators, policy-makers, and other market participants must consider the practical implications resulting from the relationship between the U.S.-based firms and the global networks.

Recommendation 3. Recommend the PCAOB, in consultation with auditors, investors, public companies, audit committees, boards of directors, academics, and others, determine the feasibility of developing key indicators of audit quality and effectiveness and requiring auditing firms to publicly disclose these indicators. Assuming development and disclosure of indicators of audit quality are feasible, require the PCAOB to monitor these indicators.

A key issue in the public company audit market is what drives competition for audit clients and whether audit quality is the most significant driver. Currently, there is minimal publicly available information regarding indicators of audit quality at individual auditing firms. Consequently, it is difficult to determine whether audit committees, who ultimately select the auditor, and management are focused and have the tools that are useful in assessing audit quality that would contribute to making the initial auditor selection and subsequent auditor retention evaluation processes more informed and meaningful.¹⁵⁶ In addition, with the majority of public companies currently putting shareholder ratification of auditor selection to an annual vote, shareholders may also lack audit quality information important in making such a ratification decision.¹⁵⁷

The Committee believes that requiring firms to disclose indicators of audit quality may enhance not only the quality of audits provided by such firms, but also the ability of smaller auditing firms to compete with larger auditing firms, auditor choice, shareholder decision-making related to ratification of auditor selection, and PCAOB oversight of registered auditing firms.

The Committee recognizes the challenges of developing and monitoring indicators of audit quality, especially in light of the complex factors driving the potential impact on the incentives of market actors, and the

bankruptcy and emerged to continue its practice. The hard assets of the firm are not significant: the professionals and the clients are the lifeblood of the registered firm. With any anticipation of bankruptcy, these mobile assets are gone.”)

¹⁵⁶ See, e.g., New York Stock Exchange, Listed Company Manual § 303A, which the SEC approved on November 4, 2003, for the responsibilities of exchange-listed companies' audit committees.

¹⁵⁷ Institutional Shareholder Services, U.S. Corporate Governance Policy—2007 Updates 3 (2006).

resulting effect on competitive dynamics among auditors.¹⁵⁸

The Committee has considered testimony and comment letters¹⁵⁹ as well as other studies and reports in developing this recommendation. A possible framework for PCAOB consideration is reviewing annual auditing firm reports in other jurisdictions. For example, one auditing firm's United Kingdom affiliate lists in its annual report nine “key performance indicators, including average headcount, staff turnover, diversity, client satisfaction, audit and non-audit work, proposal win rate, revenue, profit, and profit per partner.”¹⁶⁰ The Financial Reporting Council recently published a paper setting out drivers of audit quality.¹⁶¹ In addition, the PCAOB also could consider some of the factors that auditing firms present to audit committees, such as engagement team composition, the nature and extent of firm training programs, and the nature and reason for client restatements.¹⁶²

The Committee therefore recommends that the PCAOB, in consultation with auditors, investors, public companies, audit committees, boards of directors, academics, and others, determine the feasibility of developing key indicators of audit quality

¹⁵⁸ If the idea proves to be workable, implementation could be a major undertaking for the PCAOB. Developing meaningful quality indicators, defining how they should be measured, and rolling out the measurement process could take significant PCAOB time and effort. Auditing firms, public companies, investors, and academics would all likely have valuable ideas as to approaches the PCAOB could take. However the indicators were devised, firms would have to build their internal processes for measuring the audit quality indicators and the PCAOB would have to develop procedures and training to monitor those processes.

¹⁵⁹ See, e.g., Record of Proceedings (Dec. 3, 2007) (Written Submission of Wayne Kolins, National Director of Assurance and Chairman, BDO Seidman LLP, 4), available at <http://www.treas.gov/offices/domestic-finance/acap/submissions/12032007/Kolins120307.pdf> (recommending the issuance of regulatory guidance on qualitative factors to be used to evaluate auditing firms); Record of Proceedings (Dec. 3, 2007) (Written Submission of Dennis M. Nally, Chairman and Senior Partner, PricewaterhouseCoopers LLP, 6), available at <http://www.treas.gov/offices/domestic-finance/acap/submissions/12032007/Nally120307.pdf> (suggesting that disclosure of “key elements that drive audit quality would be a useful benefit to the capital markets” and could include a “discussion of the levels of partner and staff turnover, average hours of professional training, risk management and compliance measurements, and metrics related to the quality of management and firm governance processes”); Anonymous Retired Big 4 partner, Comment Letter Regarding Discussion Outline (Nov. 2007) (recommending public disclosure of the following audit quality drivers: (1) Average years of experience of audit professionals, (2) ratio of professional staff to audit partners, (3) chargeable hours per audit professional, (4) professional chargeable hours managed per audit partner, (5) annual professional staff retention, and (6) average annual training hours per audit professional).

¹⁶⁰ See KPMG LLP, UK Annual Report 2007 46.

¹⁶¹ FRC Update 4.

¹⁶² Record of Proceedings (Dec. 3, 2007) (Written Submission of Wayne Kolins, National Director of Assurance and Chairman, BDO Seidman LLP, 2), available at <http://www.treas.gov/offices/domestic-finance/acap/submissions/12032007/Kolins120307.pdf>.

¹⁵⁴ See, e.g., Securities and Exchange Commission, Temporary Final Rule and Final Rule: Requirements for Arthur Andersen LLP Auditing Clients, SEC Release No. 33-8070 (Mar. 18, 2002); Securities and Exchange Commission, Press Rel. No. 2002-39 and Order Rel. No. 33-8070 (March 18, 2002) (indictment of Arthur Andersen); SEC Staff Accounting Bulletin No. 90 (Feb. 7, 1991) (bankruptcy of Laveneth & Horwath).

¹⁵⁵ Record of Proceedings (Dec. 3, 2007) (Written Submission of James R. Doty, Partner, Baker Botts L.L.P., 11), available at <http://www.treas.gov/offices/domestic-finance/acap/submissions/12032007/Doty120307.pdf> (Dec. 3, 2007) (“It is an anecdotal but firmly held perception of the profession that no accounting firm has entered